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Report to Congressional Requesters

September 1996

NAVY DEPOT MAINTENANCE

Cost and Savings Issues Related to Privatizing-in-Place at the Louisville, Kentucky, Depot



GAO/NSIAD-96-202
Report to Congressional Requesters
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National Security and
International Affairs Division

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September 18, 1996

The Honorable Floyd Spence
Chairman
The Honorable Ronald Dellums
Ranking Minority Member
Committee on National Security
House of Representatives

The Honorable Norman Sisisky
House of Representatives

The Department of Defense (DOD) is planning to reallocate depot maintenance workloads from depots recommended for closure or realignment by the 1995 Defense Base Closure and Realignment (BRAC) Commission. DOD is considering privatization-in-place for several of these depots. You asked that we review plans to privatize workloads in place rather than move the workload to remaining depots. Specifically, we are reviewing each of the services' privatization-in-place initiatives to determine the (1) impact on excess depot capacity and operating costs at the remaining industrial facilities, (2) cost-effectiveness of planned privatization-in-place options, and (3) compliance with statutory requirements affecting transfers of depot maintenance workloads to the private sector. Although our work is still ongoing, you requested that we report now on the Navy's plans to privatize-in-place its depot workload at Louisville, Kentucky. You needed this information because the Navy notified Congress of its intent to award contracts for the Louisville, Kentucky, depot workload using other than competitive procedures. We will be reporting separately on privatization-in-place initiatives involving Air Force and Army depots.

Background

Since the early 1970s, we and others have reported on redundancies and excess capacity in DOD depots. The excess capacity problem has been exacerbated in recent years by reductions in military force structure and related weapon system procurement; changes in military operational requirements due to the end of the Cold War; and the increased reliability, maintainability, and durability of military systems. We recently determined that excess capacity in the DOD depot maintenance system is about

40 percent for fiscal year 1996.¹ Additionally, the private sector, which has seen its production workload for new systems and equipment decline and has significant excess production capacity, is seeking an increased share of the depot maintenance workload.

The BRAC process of closing or realigning depots and transferring their workloads either to remaining depots or to the private sector has, in the past decade, been the most effective way of addressing DOD's problem of excess capacity.² During the 1995 BRAC process, one of DOD's recommendations was to close the Louisville depot and transfer its workload to other Navy facilities—primarily the naval gun workload to the Norfolk Naval Shipyard, Virginia; the Phalanx workload to the Naval Surface Warfare Center, Crane, Indiana; and the engineering support functions to the Naval Surface Warfare Center, Port Hueneme, California.

Concerned with the potential economic impact, the city of Louisville suggested an alternative public-private partnership between the Navy, a local community group and two private contractors. It proposed privatizing the Navy's operation of the Louisville facility with two private contractors. After considering the privatization goals cited by the Commission on Roles and Missions and the merits of the proposed cooperative venture, the BRAC Commission urged the Navy to allow privatization of the Louisville facility. Thus, in adopting DOD's recommendation to close Louisville, the Commission recommended

"transfer(ing) workload, equipment, and facilities to the private sector or local jurisdiction as appropriate if the private sector can accommodate the workload on site; or relocate necessary functions along with necessary personnel, equipment, and support to other naval technical activities, primarily the Naval Shipyard, Norfolk, Virginia; Naval Surface Warfare Center, Hueneme, California; and the Naval Surface Warfare Center, Crane, Indiana."

The Louisville Detachment of the Naval Surface Warfare Center, Crane Division, is located on a 142-acre site within the city limits of Louisville,

¹Capacity and workload statistics are described in direct labor hours. In computing excess capacity, we subtracted programmed fiscal year 1996 workload from projected maximum potential capacity, assuming a 5-day workweek, one 8-hour-per-day shift operation. Maximum potential capacity is the assessment of the maximum number of direct labor hours that a depot can produce, given existing equipment and facilities and no manpower constraints.

²The Defense Base Closure and Realignment Act of 1990 (P.L. 101-510) created independent BRAC commissions and outlined procedures, roles, and time frames for the President, Congress, DOD, GAO, and the commissions to follow in identifying, reviewing, approving, and implementing base closures and realignments.

Kentucky.³ The Louisville depot is responsible for providing engineering and technical support as well as overhaul and remanufacturing capability for naval surface ship gun and missile systems, including the 5-inch Mark 45 and Mark 75 guns, missile launchers, gun computer and fire control systems, torpedo tubes, and the Navy's anti-missile Phalanx Close-In-Weapon System. Louisville has nine major production buildings with approximately 1.4 million square feet of plant space. The facility provides a wide range of mechanical capability, including weapon system disassembly and assembly, gun manufacturing, machining, component fabrication, welding, metal plating, and surface finishing. The depot has 3.8 million direct labor hours of maximum potential capacity to perform 1.3 million hours of work, leaving the facility with 2.5 million hours of excess capacity and only 34 percent utilization.⁴ At the time of the BRAC decision, the depot employed approximately 1,600 civilian personnel.

The Navy is planning to privatize the workload in place in the Louisville facility. On June 13, 1996, the Secretary of the Navy notified Congress that, under the Competition in Contracting Act, the Navy intended to award contracts restricting competition in the public interest to the two defense contractors selected by the local redevelopment authority. The Navy awarded contracts to Hughes Missile Systems Company and United Defense Limited Partnership on July 19, 1996.

Results in Brief

As we stated in April 1996 testimony on depot maintenance before the Readiness Subcommittees of the House National Security Committee and Senate Armed Services Committee, deciding the future of the DOD depot system is difficult. Depot maintenance privatization should be approached carefully, allowing for evaluation of economic, readiness, and statutory requirements that surround individual workloads. Privatizing depot maintenance activities, if not effectively managed, including the downsizing of remaining DOD depot infrastructure, could exacerbate existing capacity problems and the inefficiencies inherent in underutilization of depot maintenance capacity. Privatization-in-place does not appear to be cost-effective given the excess capacity in DOD's depot maintenance system and in the private sector.⁵

³In April 1991, the Navy realigned the Naval Ordnance Station, Louisville, Kentucky, under the Naval Surface Warfare Center and made it a detachment of the Naval Surface Warfare, Crane Division. The Crane Division is located in Crane, Indiana, and is one of five divisions included as part of the Naval Surface Warfare Center.

⁴The Navy certified this figure for Louisville's 1996 maximum potential capacity during the 1995 BRAC process.

⁵Defense Depot Maintenance: Privatization and the Debate Over the Public-Private Mix (GAO/T-NSIAD-96-146, Apr. 16, 1996) and (GAO/T-NSIAD-96-148, Apr. 17, 1996).

The Navy's plan for privatizing the workloads in place at the Louisville depot will not reduce excess capacity in the remaining public depots or the private sector, may prove more costly than transferring the work to other depots, and does not appear to be consistent with an existing statutory requirement for public-private competitions. In recommending the Louisville closure, the Navy proposed transferring 1.5 million direct labor hours, representing about 850 staff years, to the Norfolk Naval Shipyard and Crane and Port Hueneme sites of the Naval Surface Warfare Center. Norfolk and Crane have 5.4 million and 1.6 million hours of excess capacity, respectively. Moreover, excess capacity will still persist in the private sector, including facilities owned by the two defense contractors selected to operate and manage the privatized Louisville depot.

The Navy's preliminary cost analysis that privatization-in-place is cost-effective is based on limited cost data that overstates the cost of relocating the workloads by at least \$66 million and on the general assumption that privatizing workloads will save 20 percent. The projection was based on conditions that are not relevant for most depot maintenance workloads and does not reflect the cost of excess capacity in the public sector. Moreover, we have previously reported that the goal of achieving 20-percent savings by privatizing depot maintenance workloads is not likely to be reached.⁶

On July 19, 1996, the Navy completed its cost analysis of the Louisville privatization-in-place and awarded contracts to United Defense and Hughes for work in process, with unpriced options for fiscal years 1997 through 2001. According to DOD officials, the estimated annual recurring costs of performing the work at the privatized Louisville facility will be greater than the cost of performing the work at the Navy sites. However, the impact of factoring in a \$243 million one-time cost of transferring the workloads to these sites more than offset the annual savings during the first 5 years. As a result, the Navy's analysis showed a 5-year savings of \$60 million from privatization-in-place. We are in the process of reviewing the Navy's analysis and as agreed with your offices we will be reporting the results of that work separately. However at this point it is clear that the Navy's analysis factored in the costs of transferring the workloads, but did not factor in annual savings that would result from reduced overhead costs per workload at the receiving locations.

⁶Defense Depot Maintenance: Commission on Roles and Mission's Privatization Assumptions Are Questionable (GAO/NSIAD-96-161, July 15, 1996).

Several statutes may affect the privatization of depot maintenance workloads. A key provision is 10 U.S.C. 2469, which requires a competition between public and private entities before privatizing DOD workloads valued at not less than \$3 million. We have not been able to identify any element of the Navy's plan for privatization of the Louisville depot that addresses the 10 U.S.C. 2469 requirement.

Navy Plans Do Not Reduce Excess Capacity in the Public or Private Sector

Because the Navy plans to privatize the Louisville depot's current workload in place, neither excess capacity nor associated maintenance costs will be reduced at other DOD depots or the private sector. The 1994 Defense Science Board Task Force on Depot Maintenance Management, which included representatives from the public and private sectors, stated that divestiture of excess infrastructure is a key element of reducing overall depot maintenance costs. Private industry representatives pointed out that through consolidations, mergers, and closures, the defense industry has attempted to address its significant excess capacity problem and DOD needs to do the same. Privatizing-in-place transfers excess capacity to the private sector but does not eliminate it. DOD pays for this excess capacity, whether it is in the public or the private sector.

DOD has had little success eliminating underused industrial facilities except through the BRAC process. In making its recommendations to the BRAC Commission on the Louisville closure, the Navy proposed transferring 402,500 direct labor hours to the Norfolk Naval Shipyard and about 925,750 and 187,250 direct labor hours to the Crane and Port Hueneme locations, respectively, of the Naval Surface Warfare Center. Based on an evaluation of maximum potential capacity and programmed workload for fiscal year 1996, naval shipyards had 35-percent excess capacity, representing 18.5 million direct labor hours. The Norfolk Naval Shipyard has 34-percent excess capacity, representing about 5.4 million direct labor hours, and Crane has 69-percent excess capacity, representing about 1.7 million direct labor hours. The Navy has started to privatize these workloads in place at Louisville. Consequently, an opportunity to reduce excess capacity at the other Navy industrial activities is missed.

In developing its privatization-in-place plans, the Navy did not consider consolidating the Louisville workloads with comparable workloads in contractor facilities. United Defense Limited Partnership and Hughes Missile Systems Company, which will operate the Louisville site, also have extensive excess capacity in their own facilities. Although these are

manufacturing rather than repair facilities, they have significant excess capacity the contractors believe could be adapted for repair.

Louisville Privatization-in-Place May Not Be Cost-Effective

The Navy believes that privatization of the Louisville depot will minimize the impact of the closure on the local community and will produce substantial savings. However, the Navy's position on savings is not well supported. Navy officials cited several reasons why privatization would produce savings. First, the Commission on Roles and Missions concluded that privatizing depot maintenance activities could lower DOD depot maintenance costs by 20 percent.⁷ Second, although Navy officials said they would not complete their cost analysis until the day before they expect to award contracts for the Louisville workloads, their preliminary analysis indicates that privatization is less expensive. Third, the city of Louisville required contractors to commit to reducing labor rates below the current Navy rates.

Savings From Competition Will Not Likely Be Realized

The Commission's assumption that privatization can reduce costs by 20 percent is not well supported, as we reported in July 1996.⁸ The Commission's assumption was based primarily on reported savings from public-private competitions for commercial activities under Office of Management and Budget Circular A-76. Unlike depot maintenance activities, which require large investments in capital equipment, technical data, and highly trained and skilled personnel, these commercial activities involved simple, routine, and repetitive tasks. Also, public activities won about half of these competitions. The A-76 competitions generally had many competitors—unlike depot maintenance where most contracts are awarded without competition. Further, reports by us and defense audit groups indicate that projected savings from the A-76 competitions were often not fully achieved. Lastly, there was no competition between Hughes and United Defense and other contractors for the Louisville workloads.

In its June 13, 1996, letter to Congress, the Navy stated its awards are in the public interest since the Louisville redevelopment authority had already competitively selected the two contractors. However, our review

⁷The report, entitled Directions for Defense (May 24, 1995), by the Commission on Roles and Missions, was forwarded to Congress on August 24, 1995. The Commission recommended that because of the potential savings, DOD should privatize essentially all existing depot-level maintenance. It reported that these savings would result from "meaningful competition," which was defined as a competitive market that included significant numbers of both buyers and sellers.

⁸Defense Depot Maintenance: Commission on Roles and Mission's Privatization Assumptions Are Questionable (GAO/NSIAD-96-161, July 15, 1996).

does not support the Navy's position that a competition occurred. In June 1995, prior to the completion of the BRAC process, the city of Louisville entered into an agreement with Hughes and United Defense to operate the Louisville depot maintenance facility in the event of a BRAC decision.⁹ On July 1, 1995, the BRAC Commission forwarded its closure and realignment recommendations to the President, who forwarded the report to Congress on July 13, 1995. Congress completed its review and accepted the Commission's recommendations in September 1995.

In a December 1, 1995, letter, the Navy asked the Louisville redevelopment authority to reaffirm that it was finalizing its agreements with Hughes and United Defense. In February 1996, another contractor submitted an unsolicited business concept offering to the city of Louisville for the management and operation of the Louisville facility. In a February 24, 1996, letter to the local redevelopment authority, the Navy expressed concern that the community might open its selection process to competition. The Navy letter stated that the "introduction of a competitor in Louisville will complicate the interface between the [Navy] depot and the original equipment manufacturers." On March 5, 1996, the Navy wrote the redevelopment authority urging it to make its decision no later than March 7, 1996. According to redevelopment authority officials, on March 7, 1996, they advised the three contractors that the redevelopment authority board had decided not to hold a competition and the workloads would be awarded to Hughes and United Defense.

Navy's Preliminary Cost Analysis Is Inaccurate and Incomplete

As of July 10, 1996, Navy officials said they had not fully developed a cost model for evaluating the two options planned for consideration and had not determined what cost elements would be evaluated. However, they expected to complete their final analysis prior to contract award, which was expected on July 15, 1996. Under the first option, which the Navy indicated in its June 13, 1996, congressional notification letter, the Navy planned to award contracts for the Louisville workloads, assuming it determines that privatization is the more cost-effective alternative. The second option was to transfer workloads to Navy facilities the 1995 BRAC process identified as candidates to receive the Louisville workload. Navy officials expected the first option to be more cost-effective based on a preliminary comparison of the estimated one-time transition costs and their assumption that a contractor will have lower recurring costs.

⁹The two contractors are the original equipment manufacturers for much of the ordnance currently maintained or repaired at the Louisville depot.

However, the data used in this comparison were inaccurate and incomplete.

In June 1995, the Navy estimated that transferring the workload to other naval facilities would cost about \$302 million. In March 1996, the Navy estimated that it would cost \$132 million, or \$170 million less, to privatize-in-place and retain a small Navy engineering support activity at Louisville. Based on these preliminary estimates, the Navy concluded that privatization-in-place was more cost-effective. This analysis did not consider all recurring costs and savings.

Transition Cost Estimates Are Inaccurate

Some factors in the Navy's June 1995 one-time cost estimates for transferring the workload to other Navy sites are overstated. For example:

- The average cost factor used for permanent change-of-station moves was higher for the transfer option than the privatization-in-place option. Under the March 1996 privatization option cost estimate, the Navy estimated it would cost an average of \$26,400 to move each of the 409 employees projected to take government jobs, which was about \$3,000 lower than the figure developed by the Navy for the BRAC 1995 process. In contrast, the June 1995 estimate for transferring the workload included an average cost of \$48,145 to move 819 employees. The two estimates have a difference of \$21,745 per person. We could find no reason why the Navy used higher costs for the depot transfer option. However, assuming that \$26,400 is the accurate cost factor, the transfer option is overstated by about \$17 million.
- The overstatement of the permanent change-of-station costs also overstated the estimate for DOD's relocation income tax allowance program. The program, which compensates individuals for federal income taxes incurred on permanent change-of-station payments, is based on a percentage of the payments received. The Navy's estimate overstated the program's cost estimate by \$2.4 million.
- The workload transfer cost estimate included \$36 million to overhaul larger numbers of spares than normally required to satisfy demands. This was included because the Navy believed extra stock would be needed as a cushion during the transition period. However, normal customer sales would generate about \$32 million; therefore, this figure should not have been included in the transfer option. The appropriate cost estimate was an additional \$4 million that will not be recovered through customer sales.
- The workload transfer cost estimate included \$37.6 million for military construction at the Norfolk Naval Shipyard. During its fiscal year 1997 budget review, the Navy later determined this estimate was overstated by \$11.2 million.

- The workload transfer estimate included about \$2.2 million for DOD's homeowners assistance program, under which DOD offers to buy an employee's house if it cannot be sold and provides compensation for some property value losses. According to Navy officials, since this program will not be available for Louisville depot employees, their initial cost estimate should not have included this cost for the transfer option.

The one-time cost estimate of \$302 million for transferring the Louisville workload is overstated by about \$66 million, as summarized in table 1. We attempted to analyze other cost factors used in the depot transfer option and noted other costs were potentially overstated, such as those for the employee assistance program and equipment shipment and reinstallation. However, we have not yet developed a more realistic cost for these factors. Nonetheless, because the Navy used preliminary estimates developed for budget purposes, further evaluation is needed.

Table 1: GAO and Navy Estimates of One-Time Transition Costs

	Costs of transferring workload	
	GAO	Navy
Military construction	\$32,790	\$43,990
Environmental	11,204	11,204
Civilian personnel	69,609 ^a	89,860
Equipment relocation	43,386 ^a	43,386
Operations and maintenance (other than civilian personnel, equipment relocation, and other operations and maintenance)	34,477	34,477
Other operations and maintenance	41,882	74,282
Homeowner Assistance program	0	2,162
Other nonoperations and maintenance	2,759	2,759
Total	\$236,107^a	\$302,120

^aThis figure could be lower because other transfer option cost elements, such as employee assistance programs and equipment shipment and reinstallation costs, were potentially overstated.

Privatization-in-Place Estimate Appears to Be Understated

In March 1996, the Navy estimated it would cost \$132 million to privatize the Louisville depot in place, but this estimate appears to be understated. Based on our preliminary analysis, understated costs include (1) consolidation of equipment to reduce the facility's size and more efficiently use capacity, (2) incentives paid to contractors for hiring displaced Navy employees, and (3) separation incentives. On July 15, 1996,

when we provided a draft of this report to DOD for comment, the Navy was revising its estimates for the costs of privatization-in-place. Subsequently, in a July 19, 1996, letter to the House Committee on National Security and the Senate Committee on Armed Services, the Navy reported that its updated cost analysis showed that privatizing the Louisville workload rather than transferring it to other Navy depots should save \$60 million—a reduction of about \$110 million in savings from its earlier estimate. Our preliminary analysis of the initial cost estimates are presented below. As you requested we are in the process of reviewing the Navy's updated cost analysis and will report the results of that work later this year.

Transferring Workload to Other Navy Sites Appears to Be Cost-Effective

Our previous BRAC work shows that consolidating depot maintenance workloads can significantly reduce recurring costs for all workloads in the remaining facilities. However, choosing the best option requires assessing both one-time transition costs and recurring costs of operation after the transition period.

As of July 10, 1996, Navy officials had not yet determined the impact of transferring the Louisville workload on recurring maintenance costs for all workloads at other Navy activities. At that time, they noted that, although they may consider this factor in their final cost analysis, no decision had yet been made to do so. We estimated the potential savings if the Louisville workloads were consolidated at other Navy facilities by (1) using labor rate data from the three potential receiving locations and (2) revising it to reflect the overhead costs that would be reduced by spreading fixed overhead costs over a larger workload base. Using hour and rate information from contractor proposals, we also calculated the estimated annual costs for the privatization option. Based on these estimates, we projected that the Navy could achieve recurring annual savings of about \$47.8 million through workload transfers to the Navy activities originally identified to receive these workloads.

Our calculations are based primarily on lower rates for workloads currently at Norfolk and Crane, which occurred by increasing the use of these facilities. This projection does not include the \$31 million the Commission estimated would be saved by eliminating personnel and operating costs at Louisville. Combining these savings with the \$47.8 million resulting from transferring workloads results in an annual savings of about \$78.8 million. Therefore, even with one-time transfer costs of \$236 million (see table 1), the Navy could recoup the transition costs within 3 years and begin to save \$394 million over 5 years. Given this

opportunity for savings, privatization-in-place does not appear to be the most cost-effective approach.

Potential for Future Reductions in Contractor Rates Uncertain

The Navy expects Hughes and United Defense to lower hourly rates as they gain experience and add comparable commercial work to their Louisville operations. Accomplishing this goal is uncertain because, although the contractors have already agreed with the Louisville reuse authority to reduce labor costs, they also agreed to retain a certain level of the existing workforce and to guarantee current pay and benefits. The Navy did not incorporate these agreements into its contract solicitations. It opted for cost-type contracts.¹⁰ Further, the contractors might also have trouble attracting commercial workload to the Louisville facility, particularly in light of the age and condition of the equipment and facilities. One contractor official told us the Louisville facility is in worse condition than any other owned or operated by his company. Thus, it is questionable whether the expected efficiency gains will be achieved.

Navy Has Not Assessed Risk of Contracting Core Louisville Workload

Title 10 U.S.C. 2464 provides that DOD activities should maintain a core logistics capability sufficient to provide the technical competence and resources necessary for effective and timely response to a mobilization or other national defense emergency. Navy data submitted during the 1995 BRAC process indicated that about 95 percent of the Louisville workload was mission essential, needed to support contingency requirements, and considered necessary to sustain core capabilities. In an April 1996 report to Congress on depot maintenance policy, DOD required the military services to conduct a risk assessment before privatizing mission-essential workloads.¹¹ DOD officials stated that qualitative factors have been established for conducting a risk assessment and that privatization is determined to be an acceptable risk when an adequate number of private sector sources exist, and those sources are economical, possess the capability and capacity to do the work, and have demonstrated proven past performance. According to Navy officials, they did not perform a risk assessment for the Louisville depot maintenance workloads.

¹⁰In the past we have reported that this type of contract often experiences cost growth, resulting in program costs being higher than projected.

¹¹Report on Policy Regarding Performance of Depot-Level Maintenance and Repair, Department of Defense (Apr. 4, 1996).

Statutes Affect Efforts to Privatize Workloads

As we previously reported, various statutory restrictions may affect how much DOD depot-level workloads can be converted to private-sector performance, including 10 U.S.C. 2464, 10 U.S.C. 2466, and 10 U.S.C. 2469. Title 10 U.S.C. 2464 provides that the Secretary of Defense must identify a "core" logistics capability and DOD must maintain it unless the Secretary waives DOD performance as not required for national defense.

Titles 10 U.S.C. 2466 and 10 U.S.C. 2469 limit the extent to which depot-level workloads can be converted to private-sector performance. Title 10 U.S.C. 2466 specifies that not more than 40 percent of the funds allocated in a fiscal year for depot-level maintenance or repair can be spent on private sector performance—the so-called "60/40" rule. Title 10 U.S.C. 2469 prohibits DOD from transferring in-house maintenance and repair workloads valued at not less than \$3 million to another DOD activity without using "merit-based selection procedures for competitions" among all DOD depots or to contractor performance without the use of "competitive procedures for competitions among private and public sector entities."

Although each statute affects the allocation of DOD's depot-level workload, 10 U.S.C. 2469 is the primary impediment to privatization without a public-private competition. The current competition requirements of 10 U.S.C. 2469 were enacted in 1994 and apply to all changes to depot-level workload valued at not less than \$3 million currently performed at DOD installations, including the Navy depot at Louisville. The statute does not provide any exemptions from its competition requirements and, unlike most of the other laws governing depot maintenance, does not contain a waiver provision. Further, there is nothing in the Defense Base Closure and Realignment Act of 1990—the authority for the BRAC recommendations—that, in our view, would permit the implementation of a recommendation involving privatization outside the competition requirements of 10 U.S.C. 2469.

As noted earlier, the BRAC recommended that the Louisville depot be closed and that the "workload, equipment and facilities" be transferred

"to the private sector or local jurisdiction as appropriate if the private sector can accommodate the workload on site; or relocate necessary functions along with necessary personnel, equipment and support to other technical activities, primarily the Naval Shipyard, Norfolk, Virginia; Naval Surface Warfare Center, Hueneme, California; and the Naval Surface Warfare Center, Crane, Indiana."

The Navy is privatizing Louisville's depot-level workload in place by awarding two contracts to private firms selected by the local redevelopment authority. The Navy concluded that privatizing Louisville's workload will be more cost-effective than transferring it to the naval facilities identified in the BRAC recommendation.

In reviewing the Navy's privatization-in-place plan, we asked Navy officials to explain how the plan complied with existing statutory restrictions. They said they were "seeking to execute" the first alternative of the BRAC recommendation and would not award a contract until they evaluated the relative cost of the two alternatives. They did not provide details to support their position that the privatization plan conformed to existing statutory restrictions, and we were not able to identify any element of the plan that addressed the 10 U.S.C. 2469 requirement for a public-private competition.

Recommendations

We recommend that the Secretary of Defense direct the Secretary of the Navy, before exercising any contract options for the Louisville depot maintenance workloads, to

- ensure military depots have the required capability needed to sustain core depot repair and maintenance capability and adequately document a risk assessment for privatizing mission-essential work being considered for privatization;
- at a minimum, revise the Navy's cost analysis to reflect the annual cost savings from workload transfers on the workloads currently performed at those locations by spreading the fixed costs over the increased workload; and
- use competitive procedures, where applicable, to ensure the cost-effectiveness of the Louisville privatization-in-place initiative.

Agency Comments and Our Evaluation

DOD provided oral comments on our draft report. DOD disagreed with our conclusion that privatization transfers excess capacity to the private sector rather than eliminates it. DOD officials stated that privatization-in-place allows private industry to rightsize the facility and workforce, eliminating the excess capacity that may have existed in the government-run facility. We agree that privatizing-in-place allows private industry to eliminate excess capacity at that facility. Our concern is that substantial excess capacity exists in both DOD's depot system and in existing private sector industrial facilities. Privatization-in-place does not

reduce this excess capacity. For example, closing the Louisville facility and transferring the workloads to other underutilized public or private facilities would result in a greater reduction in total system excess capacity than privatizing-in-place.

DOD also disagreed with our conclusion that the Navy's privatization plan did not address the requirement, as specified in 10 U.S.C. 2469, that the Navy hold a public-private competition to determine the most cost-effective method of workload allocation. In its July 19, 1996, letter to the House Committee on National Security and the Senate Committee on Armed Services, the Navy asserted that its plan is consistent with 10 U.S.C. 2469 because (1) 10 U.S.C. 2469 does not generally apply to actions implementing a BRAC recommendation and (2) it already complied with this requirement in its cost analysis.

We have found nothing in the Closure Act or in its legislative history that would support the Navy's view that it may implement a BRAC recommendation involving privatization without complying with 10 U.S.C. 2469. While the Navy suggests that support for its position can be found in the legislative history of 10 U.S.C. 2469, the report language it cites deals only with the separate statutory requirement that DOD use merit-based selection procedures when transferring depot workloads between DOD facilities.¹²

Furthermore, we do not believe that the Navy's cost analysis constituted a public-private competition under 10 U.S.C. 2469. As previously mentioned, 10 U.S.C. 2469 requires that "competitive procedures for competitions among public and private sector entities" be used. The statute does not prescribe the elements that make up a competition, and we believe that, in any given case, the extent of competition may be affected by the legitimate mission-related needs of DOD. However, in our view, a "competition" fundamentally entails a process that provides public depots with a reasonable opportunity to offer their services and facilities and uses established criteria to compare their proposed performance with that of private firms. In this case, we are not aware of any attempt by the Navy to provide existing depots with an opportunity to offer their services to

¹²See H.R. Conf. Rep. No. 103-701, 103d Cong., 2d Sess. (1994), accompanying the National Defense Authorization Act for Fiscal Year 1995, Public Law 103-337. The fiscal year 1995 authorization act amended 10 U.S.C. 2469 to provide that workload changes within DOD are to be governed by "merit-based selection procedures" while proposed conversions to contractor performance must be based on "competitive procedures for competitions among private and public sector entities." The portion of the conference report cited by the Navy states that the "merit-based selection procedures" for transferring workload "between DOD depots should not affect the orderly transfer of workload as a result of base closure decisions." H.R. Conf. Rep. No. 103-701 at 681.

perform the Louisville workload, and there were no established criteria for comparing contractor and depot performance.

Our draft report included a recommendation for the Navy to complete a cost analysis considering the savings potential from consolidating the Louisville workload at other DOD depots and defense contractor facilities. Subsequently, DOD provided us a copy of its cost analysis, which we are currently reviewing in detail. While our analysis is still in process, it is clear that the Navy's final analysis did not factor in the savings that could be achieved annually for the workload currently performed at potential receiving locations by spreading fixed costs over the increased workload. The Navy also awarded contracts that privatized-in-place the work at Louisville. Therefore we revised our recommendations to address Navy actions prior to exercising any contract options, to include revising its cost analysis to reflect the workload transfer savings impact on existing workloads.

DOD made other technical comments on this report, and we incorporated them where appropriate. Appendix I provides our scope and methodology.

We are sending copies of this letter to the Secretaries of Defense and the Navy; the Director, Office of Management and Budget; and interested congressional committees. Copies will be made available to others upon request. If you would like to discuss this matter, please contact me at (202) 512-8412. Major contributors to this report are listed in appendix II.



David R. Warren
Director, Defense Management Issues

Scope and Methodology

We obtained documents and interviewed officials from the Offices of the Secretary of Defense and the Secretary of the Navy in Washington, D.C.; the Naval Sea Systems Command and Naval Surface Warfare Center headquarters, Arlington, Virginia; Naval Surface Warfare Center field locations at Louisville, Kentucky; Port Hueneme, California; and Crane, Indiana; and the Norfolk Naval Shipyard, Virginia. Whenever possible, we relied on information previously gathered as part of our overall review of the Department of Defense's (DOD) depot maintenance operations.

To evaluate the impact on excess capacity, we compared maximum potential capacity and programmed workload forecast data, as certified to the Joint Cross Service Group for Depot Maintenance prior to the 1995 Commission on Base Closure and Realignment. We determined current excess capacity percentages by comparing maximum potential capacity and workload forecasts for fiscal year 1996. To determine the impact of workload reallocation plans on recurring operating costs at remaining Navy facilities, we obtained direct labor hour rates for the Navy's Norfolk, Port Hueneme, and Crane sites recalculated based on the total workload transfers of 1.3 million direct labor hours from the Louisville site.

To determine the cost-effectiveness of the Navy's planned privatization in Louisville, we held discussions with local redevelopment representatives, responsible Navy management and contracting officials, and contractor representatives. Although we reviewed available documentation from the Naval Surface Warfare Center, we could not fully evaluate this analysis because the Navy had not completed its cost model at the time our field work was completed. Therefore, we reviewed historical documents and based our analysis and conclusions on available data. Since our review of the Navy's analysis is ongoing and was constrained by the preliminary nature of some cost estimates and the absence of some cost data, our analysis is based on assumptions that may change as better data becomes available. Subsequent to the completion of our field work, we were provided the Navy's updated cost analysis. As agreed with the requesters, our review of that analysis will be reported on separately.

To evaluate compliance with statutory requirements, we identified the applicable requirements and how they could affect the Navy's plans to privatize depot-level maintenance workloads. We also obtained a letter from the Naval Sea Systems Command General Counsel explaining how the Navy intends to comply with applicable statutes.

Appendix I
Scope and Methodology

We conducted our review from May 1996 through July 1996 in accordance with generally accepted government auditing standards.

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